The Feds, Not the Fed, Are the Problem

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Most people who worry about the future of the U.S. economy focus on what Alan Greenspan and the Federal Reserve will do. Their main concern is whether Mr. Greenspan will raise or lower short-term interest rates. Yet economic research over the last 25 or so years, much of it from the , says that this is one of the least important questions to ask. Government can affect the economy, for good or bad, but the ill effects of the federal government's anti-tobacco suit, for example, are likely to be far more important than what the Fed does or says about short-term interest rates.

This last quarter century of economic research has two strands. One is the rational expectations revolution that began in the late '60s and early '70s. Its leading proponent is Robert E. Lucas, Jr., a University of Chicago economist and winner of the 1995 Nobel Memorial Prize in Economic Sciences. CNN's thoughtful comment at the time of his award was that Mr. Lucas was "someone nobody ever heard of." Yet all economists who study macroeconomics -- the theory of employment, inflation, and output -- are aware of Mr. Lucas, and virtually all their research is an extension of, or a response to, his. Mr. Lucas's basic case was that people take into account available information when forming their expectations, including their expectations of government policy.

What does this mean for Federal Reserve policy? Hoover economist Thomas Sargent, one of the school's early members, pointed out that economists who pushed for an activist government policy relied on the idea that people make systematic forecast errors, and that governments could manipulate the public's forecasting errors to generate better economic performance. But one of Mr. Lucas's conclusions was that any predictable change in the money supply -- the Fed's main policy instrument -- would have no effect on gross domestic product, employment, or economic growth, and that only unpredictable changes in the money supply could affect these things. This aptly named "invariance proposition" means that no government stabilization policy can work by fooling people, because such policies must by their nature be predictable. Summing up the implications of this idea in their July 1997 article in Liberty, the economists

J.W. Henry Watson and Ida Walters wrote, "Put bluntly, the central bank can affect the economy only by acting like an unpredictable lunatic."

The second strand of economic thinking regarding financial markets led to shared Nobel economics prizes in 1990 for Merton Miller at University of Chicago, Harry Markowitz at , and William F. Sharpe at , and in 1997 for Robert Merton and Myron Scholes of Stanford. Their work on efficient markets and the use of financial derivatives as hedges against unexpected price and interest increases revolutionized financial markets. Say you're running a business whose success depends on short-term interest rates' not rising. Astute investment in financial derivatives will ameliorate the effects of rate spikes. Say you run an airline and are worried about oil prices rising, or you produce oil and fret about oil prices falling: you can hedge by buying or selling contracts in the oil futures market. Ditto if you're an exporter or importer concerned about fluctuating exchange rates.

This is why those stories so common in the '70s about major companies whose earnings were lower because of unexpected price or rate changes have now virtually disappeared. As Mr. Watson and Ms. Walters point out, almost every large firm and many small firms now use derivatives, and as a result, CEOs need no longer worry about every little wiggle in the central bank's policy. What Mr. Greenspan decides about short-term interest rates should not even appear in the top ten things CEOs need to worry about.

Other government policies are quite potent, however. Take, for instance, the Clinton administration's recent suit against tobacco companies. If that suit is not thrown out by the federal courts, no company producing any product will be safe, with potentially devastating consequences for economic growth.

Why so? The government's basic argument is that cigarette companies owe it hundreds of billions of dollars for Medicare spending on millions of people who were harmed by smoking. There are at least five major problems with its case. First, the government wants to avoid the traditional requirement that it demonstrate specific harm to specific people; if it had to, the suits would get no further than those of private plaintiffs. Second, cigarettes have not cost the federal government money but have actually saved it money -- economists have shown that by shortening life spans, smoking reduces Social Security payments by tens of billions of dollars. Therefore, there are no damages to sue for.

Third, for a suit against a harmful product to win, traditionally plaintiffs must prove that the consumers of the product didn't know the dangers. In the case of cigarettes, this claim is patently absurd: cigarette packages have carried warnings of health risks for more than 30 years. Fourth, even if smoking did cost the federal government money, it was aware of this risk back when it started Medicare in 1965. Therefore, the government took on these expenses with full knowledge of the health consequences. Fifth, the government has even charged the tobacco companies with racketeering for activities that are protected by their right to free speech. Racketeering charge No. 18, for example, is simply for sending out reprints of a magazine article on smoking. Even more extreme, racketeering charge No. 9 is for receiving a letter requesting funding for medical research.

If the feds get away with this, no one will be safe selling a product that carries any risk, which means almost any product. And firms that defend themselves against government in the public arena may find themselves charged with racketeering. On the other hand, if some brave federal judge throws out this case with prejudice, look for the stock market to rise by 10 to 15 percent.